

The Economic & Financial State of the Solomon Islands

Address by RN Hou to the Economic Association of SI (EASI) on 16th November 2001
Mendana Kitano Hotel

It is a great honor, and privilege for me to address this inaugural meeting of the EASI. Let me assure you from the outset that the formation of this Association has given me great morale boost. For a long time, it has been my own desire that such a body should be formed: which will provide a think-tank function, as well as a sounding board to the many economic issues and challenges confronting our country.

Besides, there has been very limited discussion on economic issues and other policy issues: that to me is not very healthy. For a long time, the Central Bank Solomon Islands has been somewhat *a voice in the wilderness* on economic issues. It appears economic discussions do not attract the interest of the wider community. I am convinced that economics is a subject that should concern a wider section of the community – after all it deals with matters and issues of our everyday life. In an ever-evolving world, Solomon Islanders should become involved in these discussions. More and more Solomon Islanders should be made aware of economic issues and concerns underlying this country's development. In that vein, it is heartening to note that among the Association's main objectives are included the aims to “*encouraging and promoting the study and teaching of economic science in Solomon Islands*” and, “*promoting the discussion of economic issues in Solomon Islands*”. I hope that through the Association, more Solomon Islanders will not only become interested, but also participate in economic and financial policy matters of the country.

This morning, I have been asked to talk on the “**Current Economic position and outlook of the Solomon Islands Economy**”. I will do that in three parts: **first**, by way of introduction, I will make the point that while the ethnic tensions is partly to be blamed, I will argue that the Solomon Islands economy had been experiencing stress before that due primarily to unsound public policy actions and inactions on the economic fundamentals. **Secondly**, I will provide a quick rundown of the latest developments in the main sectors of the economy. And **thirdly**, I will conclude by pointing to some policy issues and challenges facing the incoming government, with suggestions for action.

1. Introduction

1.1 The ethnic tensions have been blamed for much of Solomon Islands economic chaos in recent times, in particular the current economic downward spiral and the declining government revenues. While I would agree that the social unrest in Honiara and on Guadalcanal has exacerbated a fragile economic situation, it must be pointed out that sadly, the ethnic tensions has been used as a convenient excuse, much too often than not, by those who perpetuate this downward spiral. As a matter of fact, before the social unrest even started in late 1998, the Solomon Islands economy had already been under tremendous stress. For instance, before the Asian financial crises in 1997, public finances had already been under enormous pressure due to mismanagement and an irresponsible fiscal policy. At that time the investment climate and business activities have already been very subdued.

1.2 The economy had been riding on the back of a handful of export commodities, namely round logs, fish and palm oil in the four years previous to 1997. Copra, the traditional mainstay of the economy was already experiencing serious problems by then. The decline in the economy thereby accelerated as the country's export markets in Asia collapsed following the Asian financial crisis in 1997. The economic and structural reforms of 1997/99 provided an opportunity to reverse these trends. Evidence would suggest that the economy was recovering following the implementation of those reform programmes. However, the reforms lasted only half of the life of Parliament when the then administration was forced out of office in June 2000.

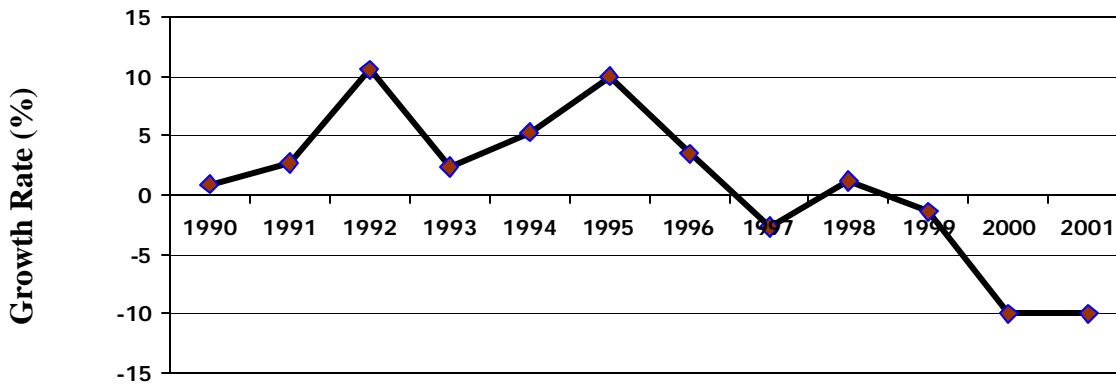
1.3 The causes to Solomon Islands economic woes can be attributed to four main reasons. **Firstly**, from mid 1990's SI has confronted *external factors*, which have had a negative, and thereby, a devastating effect on Solomon Islands macro economic stability. These include for example, declining commodity prices for its exports, and the Asian Financial crisis. **Secondly**, there are *structural factors*, which impede economic development. For example, the land tenure system, cumbersome investment procedures, unskilled labour market, small size of the economy rendering it more vulnerable to external shocks, remoteness to markets, an underdeveloped socio-economic infrastructure system, and institutional weaknesses. **Thirdly**, Solomon Island has been lacking in a *sound and coherent policy framework*, which would provide the environment for sustainable economic growth. In particular, fiscal policy for most of the last ten years had been fundamentally erratic. **Fourthly**, is the recurrence of what can be referred to as *self-inflicted perils*: such as the social/ethnic conflict of the past two years, and the heightened mismanagement of public finance in the last twelve months.

1.4 Of the four reasons, the first two are largely outside of Solomon Islands control, whereas the last two have been purely domestic creations. It is possible to achieve sustainable economic development with adverse external factors, even with structural impediments. However, where the country is endlessly overwhelmed by irresponsible domestic policies and actions, an economy as fragile and small as Solomon Islands would find it extremely difficult to sustain itself. Indeed, the ethnic tensions have punctuated the deterioration in the general security situation, which lead to the drastic decline in the economy. That is indeed the paramount concern of the investment community. It is however, no secret that ill-conceived domestic policies and actions, which have perpetuated mismanagement practices of the past, thereby paralysed the machinery for normal economic management.

1.5 The ethnic conflict, which began in 1998 culminated in the takeover of Honiara on 5th June 2000: then on, the outbreak of severe violence and breakdown of law and order. This has had deep and far-reaching effects on the economic and social life in the country as has never been before. On Guadalcanal, there was extensive damage to transport infrastructure, schools, water supply and sanitation systems, government buildings and health facilities. In Honiara the economic base for the country had been near to crippled: electricity and water supplies disrupted or damaged. The damage inflicted on the economy and social infrastructure is estimated to be over \$250 million, or about 20% of Solomon Islands GDP. These developments have disrupted and slowed down economic activity and placed severe strains on delivery of government services throughout the country. It is estimated that the economy may have declined by over 14% last year. The persistent breakdown in law and order is still the major concern to the business community and the public at large. Currently, there is very little confidence in law and order enforcement, which entails that

investor confidence will take longer to be restored. A positive economic growth will therefore be very difficult to achieve in the near future: in fact, it is forecasted that the economy will take a further fall of 10% in 2001. This will take long and dedicated work to be able to turn the current trend around. This is the task that is immediately ahead for the incoming government after the December general elections.

SOLOMON ISLANDS GDP GROWTH RATE (%)



1.6 Due the economic downturn many companies have had to reduce operations, some even closed down. Consequently, there had been a widespread of redundancies, which saw many thousands of skilled people finding themselves out of work. This is a waste of skilled human resources, let alone the many thousands of others who have been coming into the job market over the years. Though unemployment is still a foreign concept in Solomon Islands, I would stress here that it is already at the least a source of social problems in our society.

2 Production Sector

2.1 The real sector was dealt the hardest blow by the ethnic tensions. However, well before the outbreak of the conflict, some industries had already been under stress. Fish and round logs for example, experienced declining world prices. Production costs for these commodities have therefore been difficult to contain within revenue streams. Naturally, the outbreak of the crisis caused production to further decline, as the resulting security situation and deterioration in law and order finally forced operators and traders to either scale down or close operations. The long-term concern to production however, is not only the amount of damage and deterioration inflicted on economic infrastructures - which is increasing, as the production sector remains inoperative - but also the loss of investor confidence in the country's law and order enforcement. This situation has kept many important economic agents from re-opening. Surely, the damage is overwhelming, and surely it will take years to rehabilitate, and if the law and order situation is not addressed, the rehabilitation task will not start.

2.2 Given that background, the real sector is still a long way off from normal operations. Available data for the first three quarters of this year indicates that production is still below half of its capacity. The minimum objective - given the circumstances - should be to encourage existing operators to reopen before even looking at attracting new investors in to the country.

Table 1: Production by major Commodity

Commodity	1995	1996	1997	1998	1999	2000	2001		
							Q 1	Q2	Q3
Copra (metric ton)	26148	21989	28679	26971	23242	19004	636	438	130
Coconut Oil (metric ton)	2453	3520	5399	8339	10345	8553	117	-	-
Palm Oil (metric ton)	29562	28680	28863	29077	12877	-	-	-	-
Palm kernel (metric ton)	6861	6834	7005	6821	3182	-	-	-	-
Cocoa (metric ton)	2482	2464	3907	3454	2395	2316	223	881	360
Fish (metric ton)	56133	41199	40654	49390	47961	21163	1335	3074	7092
Timber/Log ('000 Cu. M)	850	792	650	604	622	536	140	134	117
Gold (' 000 Ounces)	-	-	-	45	112	50	-		-
Silver ('000 Ounces)	-	-	-	47	67	21	-		-

Source: Central Bank of Solomon Islands

2.3 Oil Palm Products: Solomon Islands Plantation Limited (SIPL) the only palm oil producer closed production in June 1999. With the closure of the company, about two thousand jobs were lost. Besides, other social amenities, which used to be provided by SIPL, including the medical clinic and school, for surrounding communities, were completely destroyed. At the same time, the local economy (on northwest Guadalcanal) which used to thrive from SIPL has ceased: income for the locals (landowners and others) from royalties, land rents, community service grants, the vegetables and meat market, and many other service providers who used to depend on the company have all ceased.

2.4 Copra and Coconut oil: A combination of factors affected production in this sector, namely declining world prices, financial problems in CEMA (Commodities & Export Marketing Authority) and RIPEL (Russell Islands Plantations Estates Ltd) and the effects from the ethnic tensions. Copra production is still going, albeit declining, while coconut oil stopped production since the beginning of 2001. Following the ethnic tensions, most copra producers on North Guadalcanal have stopped making copra. RIPEL, which is the major coconut oil producer, has also been affected due to laying off most, if not, all its Guadalcanal workforce. Several hundred employees were affected in this exercise. Internal politics at CEMA have been detrimental to the efficient running of that authority and in turn become a source of problems to farmers: these must be sorted out while RIPEL's fate is now in the hands of the liquidator.

2.5 Fish: Fish catch last year dropped by about 55% on the previous year. The reason was primarily due to poor prices, which forced National Fisheries Development (NFD) to close operations, followed by Solomon Taiyo Limited (STL) later in the year. The fishing industry would have been the least affected by the tensions, considering the locations of their operations - outside Guadalcanal. However, still STL and NFD have had to lay off almost a thousand workers and about two hundred workers respectively due to reasons associated with the conflict on Guadalcanal. However, production has picked up quite well again since the second quarter of this year. This is following improved tuna prices as of last year, as well as the resumption of activities by SolTai Fishing and Processing Ltd, the new company that took over STL operations.

2.6 Timber & Logs: Based on available data to quarter three, production this year is expected to remain within last year's levels at the most. Like the fishing sector, logging would have been least affected. However, since last year production has declined following disruptions to some of the large logging operators, notably to Earth Movers Ltd and Pacific Timbers Ltd - which operate on Guadalcanal - and Eagon Resources Ltd, which operate in Choiseul Province. Some companies have relocated to other parts of the country. But these disruptions have resulted in the loss of a few hundred jobs. The closure and non-operation of these companies also entailed loss of royalties, rentals, social amenities such as schools and clinics, and a source of income to the local communities.

2.7 Minerals: Gold Ridge mine, the only mining company in the country, began operation in 1998 and within a year of its starting, production was above its original projections¹. Following further drilling, it was discovered that the volume and value of gold deposits in the concession area is better than originally tested. The company, then brought onshore equipment intended to double the mine's original extraction rate. Installation of the equipment was in place when the ethnic unrest flared. Apart from the obvious loss of gold exports, about 300 local people lost their jobs as a result. Other services discontinued include clinic, school, many income generating projects and other professional services, which used to rely on the mine.

3. External Sector

3.1 The performance of the economy in the last several years has been heavily influenced by the performance of the external sector. Traditionally for Solomon Islands, the most critical elements of the balance of payments are the *trade and capital accounts*. Given that the real sector has been destroyed, production is now at less than half of its normal capacity. Consequently, foreign exchange earnings have dropped significantly. For the past eighteen months, temporary tightening of exchange controls have assisted with maintenance of the external reserves, but on the whole this would have been extremely difficult without the significant amounts of donor financial assistance² received this year. Since 1996, Solomon Islands has enjoyed consecutive balance of payments surpluses. However, in 2000 the overall position swung to a staggering \$97 million deficit, the highest deficit ever recorded in Solomon Islands economic history. A lot of work will be required in order to reverse this.

¹ 1996/97 projections were for an annual production of 100,000 ounces of gold over a period of eight years. Upon further drilling in 1998/99, these projections were upped to be close to 150,000 ounces of gold p.a.

² If normalcy were returned to SI economic management, about \$300 million external assistance would have been available for project mobilization during the year. However, only about \$112 million was mobilised during the year so far in specific projects: AusAid \$55 million; NZODA \$17 million; EU \$40 million and ROC provided \$33 in budget support to date. Apart from that the first two tranches of the EXIM Bank loan have been received: \$42 million in July and \$35 million in October this year.

Table 2: Balance of Payments (SBD\$ million)

	1996	1997	1998	1999	2000	2001
CURRENT ACCOUNT	39.0	-54.3	53.4	120.8	-223.6	-109.8
Merchandise Trade	155.6	32.8	67.0	193.4	-117.4	-162.0
Services	-214.8	-207.0	-96.4	-232.8	-118.9	-45.6
Income	-24.5	-30.8	-35.7	-82.0	-21.3	8.4
Current Transfers	122.7	150.7	118.5	242.2	33.9	89.4
CAPITAL & FINANCIAL ACCOUNT	-56.5	-18.6	-3.8	-95.3	111.4	81.3
Capital Account	-19.1	-3.8	34.0	44.3	67.5	0.03
Financial Account	-37.4	-14.8	-37.8	-139.6	43.9	81.3
NET ERRORS & OMISSIONS	80.7	106.7	33.4	-2.6	15.0	25.8
Overall Position	63.1	33.9	83.0	23.0	-97.2	2.7
Financing	-63.1	-33.9	-83.0	-23.0	97.2	2.7
Reserves						
Foreign Exchange	63.1	33.9	83.0	23.0	96.1	2.0
Other Claims	-	-	-	-	1.1	0.7

Source: Central bank of Solomon Islands

Note: All figures are provisional pending additional information. 2001 figures are projections

3.2 Balance of Payments: Current Account. The *current account* balance fell by more than 280% from 1999. This was largely driven by the *trade account*, which was due to an accelerated fall in exports, as against a stable trend in imports during the year: exports had been falling faster than imports. Hence, by the end of 2000, imports have fallen by 11% while exports slumped by 50%. Performance during the first half of this year showed that this trend is still continuing, albeit the *trade account* deficit has improved somewhat, as a result of a sharper contraction in imports. The movements in *services and income accounts* continue to decline given that the main source of activities – large investment projects – still remain closed. In terms of *transfers*, there has been a consistent flow of *official* as well as *private transfers*. However, these would have been outstripped by the steady outflow of gifts, subsistence and school fees in recent months. The much-heralded 1999 Stabex transfers are now to be expected next year. With the incorporation of the new fishing company SolTai, as well as NFD getting back into operation, there are positive indications that the fishing industry will be picking up in production. This is going to have a definite improvement on the *trade account*. However, the underlying trends would indicate the *current account* remains fragile.

3.3 Balance of Payments: Capital Account. Except in 1998 when there were some transactions for expansion work at the gold mine, there has been very little movement in private capital in the past three years. However, there were some large transactions in terms of official capital when the first two disbursements of the ADB and WBG loans were received in 1998 and 1999 respectively. Before June 2000 capital repayments, dividends and transfer of profits have been insignificant. However, applications for transfer of profits have been mounting to extraordinary levels in the past several months. This is signaling yet again the level of investor confidence in Solomon Islands. The first two tranches totaling \$77 million, of the EXIM Bank loan

had been received in July, and in October. These would have impacted favourably on the official capital account. However, unless investor confidence is restored in Solomon Islands, private capital activities will continue to remain low and insignificant.

3.4 External Reserves. As noted elsewhere, the dramatic fall in exports was a consequence of the production sector being adversely affected by the prevailing ethnic tensions. Since the events of June 5 last year, the external reserves have been falling at an alarming rate – \$5 million per week - until the first quarter of this year. This was due to a combination of factors namely low exports, constant imports payments and some capital transfers due to the panic and a general level of uncertainty, especially among the expatriate and business community. At the end of June 2001, the external reserves fell to \$114 million from \$151 million at the end of December 2000, a fall of \$37 million. Since then, for the past three months, the position improved, and has been stabilized at around \$120 million. That position has improved further to \$156 million at the start of November. This is equivalent to more than 2 months of imports cover, a position that has been maintained since the beginning of the year. Given that the exports base has been badly eroded, donor financial assistance has been the lifeline for Solomon Islands, which is a major reason for the stability in the level of the external reserves. Also, there has been a noticeable decline in import demand for most of the year as major companies – which consume a lot of imports - have yet to open for operation. Tighter exchange controls have also contributed to the slowing down in import demand. With the receipt of the second tranche of the EXIM Bank loan in October, and continued donor financial support, the external reserves should maintain their current levels, at least for the rest of the year. However, from next year onwards, the picture is very unclear. The resumption of fish exports is a welcomed development. However, if the new government is unable to return investor confidence and convince the international community on policy actions towards a re-direction, the balance of payments will deteriorate further to dangerous levels.

3.5 Exchange Rate. Traditionally, the exchange rate policy has been geared towards maintaining a competitive exports sector. The exchange rate has a strong influence on domestic inflation. In that regard, the policy stance, which was adopted since the major devaluation in 1997, is to keep the SBD in check with the US Dollar by maintaining a stable exchange rate. It would be argued that this policy is being maintained at the expense of the export sector. However, with the depletion of almost the entire export base, a policy shift aimed at the exports sector may not produce the desired effect: it may even undermine other policy areas. Recent movements of the SBD exchange vis a viz other major international currencies – in particular the Australian dollar - have reiterated this argument. However, a more longer-term policy approach will be needed. In the meantime, this policy stance is under close observation, subject to review: and a change may be considered as soon as the need arises.

4. Monetary Sector

4.1 Movements in the monetary aggregates reflect a subdued economic environment, which began in 1999. Business activities have therefore been very low. Except for credit, all the monetary aggregates have been declining since then. Net foreign assets (NFA) have dropped by 40% to the end of last year, with a further drop of nearly 30% to the end of the second quarter this year. NFA has remained stable above the \$100 million mark for most of the year only as a result of large official receipts during the year.

Table 4: Monetary Survey (\$SBD Million)

	1998	1999	2000				2001		
			Q1	Q2	Q3	Q4	Q1	Q2	Q3
Money Supply	438.5	458.3	450.5	441.0	458.3	460.0	420.9	421.7	401.0
-Narrow Money	220.6	264.8	248.6	238.5	239.4	248.3	232.4	243.1	244.5
-Broad Money	217.9	193.6	201.9	202.5	218.9	211.7	188.5	178.6	156.4
Domestic Credit	355.8	372.6	371.3	399.0	421.7	457.0	452.7	451.5	433.8
- Net Credit Govt.	178.0	178.3	159.9	174.1	209.0	259.1	268.8	275.1	266.9
- Cre. Private Sector	177.8	194.3	211.4	224.9	212.7	197.9	183.9	176.5	167.0
Net Foreign Assets	225.1	243.4	230.8	190.1	177.0	144.2	103.8	104.2	111.5
Excess Liquidity	78.2	32.3	8.6	6.7	39.7	32.6	52.7	57.5	51.7

Source: Central Bank of Solomon Islands

4.2 Money Supply. Domestic *money supply* has declined by 13% from the end of quarter four last year to end of quarter three this year, after remaining stable during the first two quarters. However, movements in the components of *money supply* have been mixed during the period: while *narrow money* fell by a mere 1%, *savings deposits* dropped by 26%. This is in contrast to the same period last year, which saw a very dramatic rise in *savings deposits* during the second half of the year. For this year, it can be safely assumed that the decline in money supply - particularly in savings deposits - would have gone to finance imports, which help explain the drop in NFA. There are strong indications that these developments will persist into the first quarter of next year.

4.3 Liquidity. Excess liquidity in the banking system grew quite rapidly following the events of June last year, and then remained on average at \$30 million for the rest of that year. However, since January this year, bank excess liquidity has risen to average \$57 million each month³. A reason for this high level of bank liquidity is that, since last year, bank lending has almost stood still at best. In most cases, bank credit had actually come down as customers were repaying without writing new loans. Another change in the feature of bank liquidity is that whereas in the past when liquidity included holdings of government securities, as of June last year, the definition of liquid assets includes only till cash and balances held with the Central Bank. There was no change to the definition of the liquid assets ratio (LAR) since then, but banks now prefer building up their cash holdings in their call accounts rather than expanding their loan portfolios, let alone investing in government Treasury Bills – a very good indication of the level of confidence in the government securities market.

4.4 Credit. As alluded to above, credit growth from the banks has so far been insignificant, even at times declining. At the end of 2000, *Total domestic credit* (TDC) did rise by 23% to \$457 million. This trend has slowed down this year – as at the end of September this year reaching \$434 million, a fall of 5%. This is largely due to offsetting movements between the components of TDC: *credit to private sector* remained unchanged last year, but has declined by 16% during the first nine months of 2001. On the other hand, *net credit to government* (NCG), rose by 45% to the end of last year, and has risen by a further 3% to the end of third quarter this year. Most, if not, all of these increases have been solely on account of borrowings by the government

³ At the end of September this year, surplus liquidity in the banking system was \$53 million compared with \$57 million at the end of the June quarter and \$53 million for the March quarter.

from the Central Bank. The growth in *net credit to government* has been slower this year for two important reasons: **first**, so far this year, the government has received substantial amounts of foreign exchange, which has been used in various ways. **Secondly**, the Central Bank has resisted any further abuse by the government to allow advances to the government. Given that the banking system is very liquid, and given that economic activities must be boosted, as soon as circumstances become favourable again for commercial banks lending activity, some growth in domestic credit should be allowed, especially targeted to the private sector. In the meantime however, the lid should be firmly put on further domestic borrowings by government.

4.5 Interest Rates. Movements in the weighted average interest rate have been mixed. In the commercial banks, lending interest rate has gone up from 13.8% in January last year to 15.16% in August this year, a period of eighteen months. However, deposit rates have declined from 3.12% to 0.54% during the same period. Consequently, interest margins have increased to about 15%. Call account rates have remained at 3% for the past five years⁴. Attempts to influence interest rates through the auctions Treasury Bills market have not achieved its policy objective mainly due to the non-participation of the commercial banks, which are turning deposits away as a result of the low deposit interest rates.

4.6 Inflation. The SI Statistics Office (SISO) produces inflation data. The SISO has however, been unable to produce any up to date data for a number of years. The latest information on inflation was for May 2000, which showed 6% - a significant drop considering that inflation in previous years has been anything but below 10%. This would have been the result of tight fiscal policy adopted by the new administration since its assumption of power in late 1997, as well as a stabilization of the exchange rate since 1998. The matter of the SISO not producing information is of great concern: not only is it affecting inflation, but also for trade data, national incomes and most other information that are very necessary for economic planning and decision-making. There have been attempts – and still there is interest – by donor partners to invigorate the department, but none of these attempts produced the desired effect. This is due mainly to government's non-recognition of the statistics department as important, as well as serious management capabilities at SISO itself. The government must address this matter urgently.

5. Financial Sector

5.1 Commercial banks in Solomon Islands have been profitable: last year was also profitable year for them, although the level of profit has come down quite considerably. For this year and onwards, the issue of great concern is the banks' investments in government securities, which have now become non-performing assets. Of the total amount of outstanding Bonds – the long-term debt portion - of \$242 million at the end of September this year, the commercial banks held about \$150 million. This represents 32% of the total assets of the banking system. Adding NPF's holdings to that, the financial system holds almost 90% of the total outstanding stock of government securities, and that holding represents about 31% of the total asset base of the banks and NPF. In terms of total exposure to the government, holdings by the financial system of these instruments represent 37% of the total earning assets of the entire financial system. That is a big junk of the balance sheet of the financial system. That being the case, there are serious risks to the

⁴ Banks are paid 3% interest only on their cash holdings equivalent to 7.5% of their total liability in compulsory liquid asset requirement (LAR) holdings.

stability of the financial system given the current status and condition of the government securities market. For the sake of the financial system, it is very crucial that the government securities market continues to operate because the implications for the financial system are serious if it does not⁵.

5.2 Development Bank of Solomon Islands (DBSI)

5.2.1 DBSI's struggles of the last several years are public knowledge, and even the reasons are well known. For a number of years, the bank has been plagued by ill-conceived government policy directions (including lack of direction), a loan portfolio heavily tilted towards sectors producing very little returns, and combined with management problems. Under the former government's financial sector reform program, DBSI came under review⁶. Among many recommendations, the review report strongly urged that the bank should be brought under the supervisory purview of the Central Bank. This requirement was already stipulated in the 1998 Financial Institution Act, which now requires a ministerial order for implementation.

5.2.2 A large portion of DBSI's loan portfolio has been in Honiara and Guadalcanal, and most of the bank's performing loans would be in these two locations. With the ethnic tensions, most if not, all of these assets were either destroyed or abandoned. Given that these loans may never resume activity again, the bank has lost its entire portfolio to non-performing assets. Besides, given that the bank has not recovered from its long history of cash flow problems, this has exacerbated an already desperate situation. DBSI has not had any cash injections from its usual source – the European Investment Bank (EIB) – for a number of years due to non-servicing of existing debts to that organisation. Recent attempts to find alternative sources by raising cash locally have resulted in a serious mismatch between the bank's liabilities and its loan portfolio: where the loans have a longer life as opposed to liabilities that have a short maturity. Most of these deposits⁷ have already been due but the bank has defaulted because it could not find the cash. DBSI therefore confronts real solvency risks.

5.2.3 The bank has played and will play an important role in economic development in Solomon Islands. Unlike the commercial banks, its infrastructure network still exists throughout most of the country. This network can still be utilized to enhance financial intermediation in Solomon Islands, particularly in the rural areas. DBSI should therefore be better placed to take up that role, which enhances the objective of taking financial services throughout the country. However, before it is able to do that, its current condition will have to be reversed.

5.3 National Provident Fund (NPF)

5.3.1 Like DBSI, NPF is currently in a dire cash flow situation, although the Funds' problems are more recent than DBSI's. The problems would be attributed to past management decisions, and secondly, as a result of ill-conceived directions by successive

⁵ In recognition of this potential risk, the Central Bank continues to service interest payments on all government securities

⁶ The Maxwell and Stamp Review - 1998

⁷ These deposits are more than \$10 million – one of these belongs to NPF who have not been paid since early this year.

governments on the role and function of the NPF. In terms of management decisions, the Fund has been investing a lot of its cash resources into real estates, including a property in Brisbane, which had been receiving very little returns. There was also the Board's creation of the controversial insurance firm, Solomon Mutual Insurance (SMI) that has been a drain on NPF's cash reserves until a year or two ago. As regards government actions, there are at least three amendments to the NPF Act, which now cause serious problems on the NPF cash flow. These are firstly, the reduction, from 50 to 40 years, of the age for automatic withdrawal of members' contributions. Secondly, where a member whose employment may have been terminated (for whatever reason) and who is without employment for a continuous period of at least three months, he/she would be eligible for withdrawal of their savings. This amendment has been major source for applications for withdrawal of contributions since their passing, and especially in the last three years. Thirdly, the one-third pledge of contributions to provide security for a member's commercial bank loan, where upon the member defaulting on the loan, a third of the member's contribution will be called on by the commercial bank. All these amendments have made it very easy for members to withdraw their contributions and also undermined the intentions for which NPF was originally established.

5.3.2 The economy has not been producing enough jobs to increase membership, hence those who are reaching the retiring age - and becoming eligible to withdraw their contributions - are increasing faster than envisaged. And for NPF, this is punctuated by the mass redundancies in the past three years, which has immediately resulted in lesser contributions. To date NPF has been surviving these demands on its cash reserves of past years. Its present cash flow is cannot sustain the increasing demand: contributions received average \$2 million as opposed to payments of more than twice that amount each month. Based on recent forecasts by management, their cash reserves will hold out only up to February 2002.

5.3.3 The prevailing government cash flow crisis is affecting NPF cash flow as well: for a number of years, government has not paid public officers' contributions. Up till 1998, the government owed more than \$15 million in outstanding members' contributions, which the government was repaying until last year. Treasury has been unable to quantify the current level of outstanding contributions, but it has to be assumed that this would be at least another \$20 million for the past eighteen months. Besides that, NPF is locked into the situation where it holds more than \$97 million in government securities, \$94 million of which are in long-term bonds. These holdings represent 25% of the Fund's total assets portfolio. Again this has serious implications on the Fund's earning capacity on its assets, let alone the current cash flow situation that may explode soon if not properly addressed.

5.3.4 The Financial institutions Act stipulates NPF coming under the supervision of the Central Bank. Like DBSI, the management in NPF appears very keen, but this will have to wait until ministerial orders are given. This is a matter which the new government must deal with head on.

5.4 Other Non Bank Financial Institutions (NBFIs)

5.4.1 The Credit Union movement is an important component of the financial sector. It provides a bridge between the formal banking sector and the informal sector, particularly with members. As well, it plays the important role of filling the gap left by the formal banking system. There are some problems in large credit unions – due largely to mismanagement by the members themselves. The negative effects from the ethnic tensions have affected credit unions, for instance the mass redundancies have affected employee-based credit unions. The umbrella body, Solomon Islands Credit Union League (SICUL), has not been operating well enough to look after the movement, which the Central Bank is anxiously looking at ways to address. The Financial Institutions Act has stipulated the inclusion of – large ones only – credit unions under Central Bank supervision.

5.4.2 The insurance sector appears not to be entirely under direct guidance or supervision by anyone at the moment. This is partly due to the indecision by the government as to what to do with the regulatory functions vested in the Controller of Insurance. But it is also partly due to the sector being marginalized by other more pressing issues. While I believe the Controller's office can be self-funded, the government has not given it the attention necessary to revitalize the office. Hopefully this item will attract the attention of the new government. For the moment, the office is physically located in the Central Bank, being manned by one officer, while the appointed Controller is in the Ministry of Economic Reforms and Structural Adjustment. Plans to have the office meshed with central bank functions have been advanced by the government, but the Bank is not keen on assuming too many responsibilities, especially those for which it has no statutory mandate. Also the Bank is resisting the idea, because as has been in the past, the government appeared to use the Bank as its “too hard basket” to pass on those functions and anything that has become too difficult to deal with. This option should be taken only as last resort.

5.4.3 There are other parts of the public sector that are in very serious financial and management condition. While their functions may not be directly related to the financial system, their financial condition do have implications for the banks and NPF. It appears that organizations such as the Solomon Islands Electricity Authority (SIEA), the Solomon Islands Water Authority (SIWA), the Commodities and Marketing Authority (CEMA) and the national airline, are all experiencing the same problems: very acute cash flows as well as management problems. These are public enterprises and at the same time, they all provide very essential services for the country – both for commercial as well as household needs. Most if not, all of these organizations are on the verge, if not already, of insolvency. The government owes each of them millions of dollars, and meanwhile, they are also in serious debt arrears with each other. In its present condition, the government is unable to help. Regrettably, if anything, current government policy actions are hurting these industries more than helping them. The solvency situation of these entities does have serious implications on the financial sector. For the sake of maintaining basic essential services, the government will have to address the case of these entities urgently.

6. Government Finances

6.1 The current cash flow problems in government are a direct result of serious financial mismanagement by successive governments in the last ten years. The negative effects of the ethnic tensions compounded an already fragile situation. The irresponsible financial management witnessed in the last eighteen months further exacerbated this: there was literally an absence of policy direction. At the officials level, management efforts have been overtaken by daily and weekly cash flow problem solving in the Treasury Division. The ongoing strenuous task of matching revenues with expenditures has become the preoccupation of Ministry officials, leaving very little time for policy matters. Meanwhile, at the political level, it was very obvious that nobody had the slightest inkling about what was happening on the “ground floor”.

Table 3: 2001 SIG Cash Flow and Budget Performance (SBD\$ million)

	Q1 2001		Q2 2001		Total	
	Budget	Actual	Budget	Actual	Budget	Actual
REVENUE	58.4	94.1	61.4	55.5	119.8	149.6
Inland Revenue	26.7	37.2	29.5	32.5	56.2	69.7
Customs	17.3	24.2	17.5	19.5	34.8	43.7
Other Ministries	14.4	2.7	14.4	3.5	28.8	6.2
ROC Budget Grant	-	30.0	-	-	-	30
EXPENDIURE	104.2	90.5	96.3	77.1	200.5	167.6
Payroll	38.7	46.1	38.7	49.4	77.4	95.5
Other Charges	56.1	42.9	50.4	27.5	106.5	70.4
Debt Servicing	9.4	1.5	7.2	0.2	16.6	1.7
Surplus/(deficit)	(45.8)	3.6	(34.9)	(21.6)	(80.7)	(18.0)
Memorandum item: Special Constables	-	3.8	-	7.1	-	10.9

Source: Ministry of Finance

6.1 Revenues. Following the ethnic tensions, the government revenue base was reduced by more than 50 per cent. Collections – which used to average \$500,000 daily - have declined quite significantly to less than \$100,000 daily. Ironically, actual revenue collections in the first half of the year have been above the budgeted estimates for the two main revenue departments, namely Inland Revenue and Customs and Excise Departments. However, in the third quarter, it is noted that the overall revenue collections have now declined: for Customs and Excise, collections were only \$16.2 million compared with budgeted estimates of \$17.4 million, and for Inland Revenue collections were \$32.4 million as opposed to \$33.5 million budgeted estimate for the same period. The indications are that this trend will continue, at least for the rest of this year. Two other reasons explain this trend: first, collections from “Other ministries” have not only been overestimated, but their collection process is slack. Secondly, the granting of remissions by the Minister has resulted in a significant amount of revenues forgone. Latest figures supplied by Customs department reveal that during the period from January to August 2001, \$44 million has been forfeited in respect of duty alone. Taking into account the value of Goods tax forfeited,

government may have forfeited much needed revenues totaling \$57 million⁸ during the last eight months to August. Regrettably these remissions still continue unabated. Had it not been for donor financial assistance, the government would have already hit the brick wall. Apart from specific donor assistance already mentioned, the government has received substantial amount of budget support from the Republic of China this year.

6.2 Over the past six months several initiatives have been taken by officials to address the dire financial situation. Sadly, these attempts did not eventuate due to lack of political cooperation. As recent as last month, two task forces⁹ were appointed to address the revenue and expenditures problems. Again nothing has happened since these groups were appointed.

6.3 Expenditures. The problem with public expenditures is that it has been nearly impossible to contain costs. In the last eighteen months, claims on the government have taken a new dimension, where payment of claims for compensation payments has taken priority over all normal government services. It would appear that the perpetrators of these payments have hijacked the central bills payment system so that payments of claims continue, regardless of their being justified. Besides, payroll, which would have been normally under \$155 million per annum, has been increasing due to an explosion in police recruitment since October last year. The Government workforce has increased from 8,000 pre-tension to now 10,000, and most if, not all of these new recruits are in the police force. Accordingly, payroll since then has risen significantly: for this year, of the \$96 million spent on payroll during the first half of this year, more than 11% of that amount is in respect of special constables (SCs) pay. Some expenditure items, particularly the SCs allowances¹⁰ as well as certain compensation claims, have been impossible to resist by Treasury officials without compromising personal security. The issue of bogus claims¹¹ has had, and still has very serious implications on government cash flows. The fallout from this is that these claims have been paid at the expense of normal government services¹²: government has been unable to pay provincial grants, health and education grants, house rentals and other dues for normal government services, in some cases for the past twelve months. ROC cash grants, which so far this year totaled about \$33 million, have been the lifeline for the government during the last nine months of this year. These cash grants will no doubt dry up sooner or later. And since normal revenues are also declining fast, even payroll will be hard to meet: already, payroll is in arrears by two paydays, and this is not going to improve in the coming months.

⁸ Customs Department calculation showed that the value of duty remissions granted between March and August this year is \$33.2 million; for January and February it is estimated to be \$10.3 million, making a total value of duty remissions to be \$43.5 million. Based on these figures, the estimated value of goods tax forfeited is \$13.3 million for that same period, so the total value of foregone revenues from January and August is \$56.7 million. Customs officials estimate that since the Minister has not stopped granting remissions, this amount will increase.

⁹ The two Task Forces were the Revenue Enhancement Task Force, which was headed by Hon. Tommy Chan, Minister for Forests and Conservation, and the Expenditure Control Task Force chaired by Hon. Snyder Rini, Minister of Finance. Since their inception no meetings have been convened until now.

¹⁰ Payroll increases have come in three ways: one, through Recruitment of SCs numbering about 1800 in excess of the required number; second, about 500 public officers who went into voluntary leave without pay last year have rejoined the service; and thirdly, various ex-gratio payments and allowances being paid to police officers and other public officers since last year.

¹¹ During a press conference in April this year, PM Sogavare revealed that payments totaling \$40 million in respect compensation and various other claims were bogus, for which he had announced an investigation would be carried out.

¹² As at June this year, it is estimated that unpaid grants to provinces, health and education were in excess of \$30 million. This is discounting outstanding house rentals and other trade creditors in the Treasury division.

6.4 Debt Stock and Arrears. Total government stock of debt at the end of October stood at \$1,245 million: this comprised Overseas debts of \$708 million, Domestic debt at \$469 million and Other Creditors accounted for \$60 million. At this level the stock of government debt increased by \$154 million on the June figures, which is accounted for by increases both in Overseas and Domestic Debts. On the Overseas debts about \$80 million is in respect of the EXIM Bank loan disbursements, \$6 million in respect to disbursements from the World Bank, and \$20 million were due to exchange rate movements. Domestically, the outstanding stock of auction Treasury Bills rose by \$25 million. Movements in the Monetary Operations of the auctions Treasury Bills market contributed to the increase in terms of SIG Advances with the Central Bank. Besides, there has been a further increase in government debt during the same period, most of which was attributable to increases in the SIG Advances account with the Central Bank.

6.5 The most critical aspect of government debt is the debt arrears situation, where these arrears have been growing on all fronts. To address the situation, the government will need to establish a very stern debt repayment policy and strategy, otherwise it is going to be overwhelmingly difficult to repay. A recent reconciliation of the government's total indebtedness makes staggering revelation, not only in terms of the level of indebtedness, but also the amounts that must be paid in order to normalize government debt servicing. As at October total Debt Arrears reached \$227 million: comprising \$57 million for Domestic Debt, \$33 million in respect of Overseas Debt, \$77 million in respect of CBSI Advances¹³ and \$60 million for Trade Creditors¹⁴. Projecting these outstanding amounts together with current obligations to the end of 2001, and those amounts that will be due in 2002, the government is faced with a total bill of about \$295 million to be settled in the next sixteen months. In order to regularize debt servicing, that means Treasury will have to put aside \$6 million weekly in the 2002 budget for this. Other contingent liabilities include unpaid NPF contributions for government workers for the past eighteen months, as well as an unknown number of government guarantees, some of which would be called on soon, if not already. This situation has resulted from the strategy taken by the government to disregard debt servicing. The new government certainly has a mammoth task ahead to reduce the government's mounting debts.

7. Conclusions and Policy Issues

7.1 The economic and financial troubles of Solomon Islands economy have perpetuated over the past ten years. While some blame can be rightly leveled at external causes, it has to be said that much of this is due to our own making – both actions and non-actions. On many policy fronts, actions and non-actions - especially by the government - have made the task of coming out of our economic circumstances more difficult. Fiscal policy stance and actions of the past decade, have inflicted damage to the country's economic fundamentals, and over time, have subdued attempts on other policy fronts, rendering the fundamentals to remain very weak. The negative consequences of the ethnic tensions have both highlighted and exacerbated these weaknesses.

¹³ As at October, SIG Advances from CBSI reached \$175 million. As from August 2001, this is \$77 million above the Normal Ceiling (\$98 Million) for such advances. This excess is taken as the minimum amount, which has to be repaid as soon as possible.

¹⁴ This is an estimate of the outstanding amounts representing provincial grants, health and education grants, house and office rentals, unrepresented cheques, and normal trade creditors.

7.2 There is no question that the ethnic tensions have deepened the dent in the economy. The socio-economic infrastructures have been badly damaged and the amount of deterioration since then is high. The cost of repairs and restoration of physical infrastructures is mounting so the rebuilding must start soon than later. Besides, restoration of confidence in the country – investment, the government, law and order, institutions and the people - will be most crucial to his rebuilding process. This process will be long and costly. The incoming government already has an important and very urgent agenda to attend to. The government must not only restore its due role to govern, but equally important, it must ensure it draws a sensible restoration map and to ensure it stays with it.

7.3 The list below is not conclusive, given the current state of Solomon Islands economy. Most of these areas have been noted in many statements I have made before, but I will reiterate them again. That would serve to underpin the call: that the incoming government must give special attention and address these areas if the restoration process is to start at all.

(i) Fiscal Policy

To my mind, this lies at the forefront of priority areas to address: evidence has shown that a major problem in macro-economic management in Solomon Islands over the years has been an irresponsible fiscal policy. The financial mismanagement, especially in the last year, cannot continue. This has had a dampening effect on – and subdued - the rest of the economy. Under a new fiscal policy direction, the objective is to bring stability to public finances, and to arrest the current trend in government cash flow, and restore confidence to public finances management. Actions must be taken to curb the rising expenditures, by targeting a cap on payroll and a stop to compensation claims, including all those that are still outstanding. On the revenue side, decisive measures will have to be taken to enhance revenue collection, beginning with cancellation and revocation of duty and tax remissions. Steps should be taken to reassert confidence in the securities market, and address the arrears situation – to both local and overseas creditors, with a clear debt management strategy for resumption of debt servicing in 2002. The budget process must be restored, starting with the 2002 Appropriation, and adopt a multi year budgeting approach. A clear policy on domestic credit, and a proper debt management strategy must be put in place.

(ii) External balances

The external reserves have been holding on quite well, considering the prevailing situation. However, the reasons for both their stability and the level of external reserves are unsustainable in the long term. For example, this year we have received substantial donor financial assistance and since last year the Central Bank has instituted tighter exchange controls: these are unsustainable reasons. The long term and more sustainable path is in ensuring the export sector is rebuilt. The closed sectors, including the minerals, palm oil and copra must be induced to restart as soon as possible. In the meantime, the country will need all the assistance it can possibly attract: from bilateral, multilateral as well as in terms of private capital. In order to do that, we have to create an environment and climate, which will be conducive for them. We must not forget that Solomon Islands being part of the global village, means we are competing for those same foreign capital with other parts of the

world. It would be essential to take immediate actions, which are consistent with sound macro-economic policies. The international community can only respond positively to calls for assistance if the economic fundamentals are addressed. This can only be possible in the context of a reform program. So the government would serve itself well to reach early agreement with the IMF, ADB and the World Bank on a financial and economic program, as well as with bilateral sources for sectoral and other social programmes. This is the only way, which we can secure much-needed financial assistance for reconstruction of essential socio-economic infrastructures.

(iii) Investment

Security is the first priority area to address. The security situation is so volatile that the whole investment environment is very unstable and uncertain. This is not attractive for the business community. Therefore, the priority here is for law and order to return as soon as possible, in order to revive investor confidence in law enforcement. The police force has to be reliable, and be seen to deal with crime and criminals. As far as investment is concerned, the objective is to retain existing investors: those who have closed their operations should re-open, and continue to provide an atmosphere and environment where they are confident in the long-term prospects of the country. For that to happen, it goes even beyond keeping law and order. It entails on improving security situation, a stable political government, transparent rules and regulations and so on. There are of course many other impediments to investment in Solomon Islands, which should be addressed in the most practical way and timing.

(iv) Good governance

Political groups which dominated successive governments in the last ten years have driven the Solomon Islands to the state where misappropriation of public funds, corruption, nepotism, and ignorance of normal government procedures are now a common practice at all levels of and in government. This has resulted in serious inefficiencies in government services, and a total collapse of the public service machinery. The public service is suffering from serious lapses in transparency and accountability. The objective will be to restore and encourage transparency, accountability and responsibility in government, and to ensure the political arm of government is returned to governing in its proper sense.

The concerns about good governance extend right throughout the public sector at large, including public sector enterprises. Solomon Islands is a small country and what happens in the public sector has a very direct effect on the rest of the sectors and the people in general. All Statutory authorities such as CBSI, DBSI, NPF, ICSI, SIEA, SIWA, CEMA, Solomon Airlines and so on, should be required to abide by some minimum ethical, professional, and even moral code of conduct for staff as well as of the organizations in terms of fulfilling their roles and functions. All public entities should be more open for scrutiny, for efficiency and reporting. Appointments to the Boards and top management positions must be transparent. Board members of these entities should be held more accountable and responsible for the proper management of their organizations. This will pave the way to more transparency, accountability and then creating stronger and more efficient public

institutions. If all these public enterprises were stronger and efficient, then we would have a stronger and more efficient public sector, which would be able to better support and enhance economic growth.

Good governance is an attribute of a society where integrity, moral standards and respect are upheld. As alluded to above, such it cannot be required of the government only: for it is the civil society that will demand this attribute. Sadly, Solomon Islands society and its moral fabric have deteriorated seriously in the last few years. This is being manifested in various forms: the rise in general lawlessness; lack of respect for authority; lack of respect for other people and their properties; the growing acceptance, as normal, of corruption and nepotism; theft and destruction of public properties; and the acceptance of use of violence to get what one wants. These issues cannot be quantified in monetary terms, but they have far reaching implications for the economy. Make no mistake about it: the country is losing considerably as a result of corrupt practices in public offices, vandalism in Honiara and violence around the country. The incoming government can take immediate action in addressing these issues by *empowering the public* against these archenemies to society. It can do so by allowing and empowering institutions such as the Leadership Code Commission, Ombudsman, the courts, the police and other institutions within the government machinery to eradicate this disease. The government can also empower civil society against these practices through the churches, NGOs and other civil society groups. The Government should see civil society institutions as its watchdog – not the enemy.

(v) Financial system

The financial system plays a very crucial role in the economy. Without the banks, even household and domestic activities will be extremely difficult to be sustained. Business and Commercial life would be impossible to maintain without banks. The financial system therefore must be not only be allowed to grow, but must be cared for. Its downfall will have more devastating effect on the population and the country than even the ethnic crisis. The current level of government indebtedness to the financial system is a great concern. But more critical to this concern is the fact that substantial arrears have built up to the extent that government is now unable to service its debts. Besides, the dire financial situation in most public enterprises entail solvency risks for them which in turn is cause for concern to the stability of the financial system. Government's debts to the financial system and these other internal debts should be addressed quickly in order to reduce the risks involved. This should be drawn into the overall debt management strategy. That will ensure the long-term sustainability and strength of the financial system. Also in so doing, the capabilities of the financial system can be harnessed for the benefit of the economy.

Ladies and Gentlemen, I have already taken too much of your time. But let me conclude by reiterating again that it's very important to restore law and order in our country. To my mind, very little else will move forward unless law and order is restored. A new government will be ushered in after the general elections in December. But without a safe environment, without being confident that criminals will be dealt with, and without being confident of a free environment to conduct oneself, it will be very difficult for any government to take the necessary actions. In that regard, I

am aware that many policy decisions and actions in my suggestions above, will be highly unpopular and may even be political suicide. Even in peace times, these actions will need a lot of guts, determination, and will power. In the prevailing security situation, these suggestions may even compromise personal safety and security for those who advocate them. It is too early to assume that the incoming government will be ready to bite the bullet.

Let me however, urge all of us to do what needs be done. The agenda before us is overwhelming but it needs urgent attention. This is where I want to leave the challenge with the Association. You have picked up a very noble call, and dare I say, you could not have picked it a better time than now. The Association will be looked upon as a source of inspiration, encouragement and advice on many economic issues which confront our nation. Some of you are already in key positions to provide that advice and guidance to the new government. Some of you may be outside the government machinery, but your membership in this Association gives you that opportunity to be involved in the dialogue, and to let others be aware of the issues. On the eve of a general election, this need is even more profound: that the voters should go to the polls better educated about the issues that matter in choosing a government. It is in this regard, that although the formation of the EASI may be long overdue, I think this conference is quite timely.

The EASI is going to be an important partner in the dialogue on many policy issues in the future. Like politics, economics affect all of our everyday lives. We must therefore ensure more Solomon Islanders are aware of the issues and that they become involved. Through the Association, you can influence decision-making. I can see the EASI getting more involved in economic policy making. That is not a bad start for an Association that is only two weeks old.

Ladies and gentlemen, thank you for listening!